

## Demonetisation: Govt bond prices zoom as banks struggle to invest surplus cash

**Banks have parked Rs 4.43 lakh cr with RBI after their deposits have risen significantly after demonetisation**

Anup Roy | Mumbai November 24, 2016 Last Updated at 09:13 IST



Prices of

*Bank employees count old 500 Indian rupee bank notes inside a bank in Jammu (Photo: Reuters)*

government bonds, finite in supply, are shooting up, as banks are struggling to invest the huge amount of excess deposits coming their way.

As prices of bonds rise, their yields drop. Generally, the yields on the 10-year bond are around 50-basis point (bp) above the policy rate. But, thanks to the sharp rise in demand from banks and the prospects of steep rate cuts in the coming days by the Reserve Bank of India (RBI), yields are dropping at an unprecedented rate, falling even below the repo rate of 6.25%.

The yields on the 10-year bond fell to 6.23% in intraday trades on Wednesday, lower than the repo rate of 6.25%. The bonds closed at 6.28%, against their previous close of 6.31%. This is a very rare occasion but not uncommon, as markets position to factor in future RBI rate cuts. This time though, the movement is mostly directed by demand for the bonds, say market observers and participants.

“Banks are now flush with liquidity. Instead of parking the idle cash in the reverse repo window, banks are now taking duration risk and earning more by buying bonds. Therefore, there is a huge demand for bonds,” said N S Venkatesh, executive director at Lakshmi Vilas Bank.

Thus, investors in these bonds are making a killing by selling the bonds now.

Meanwhile, rating agency Icria said on Wednesday that the treasury profits for public sector banks to surpass the budgeted capital infusion by the government.

The fall in yields is also in anticipation of a steep rate cut in the coming policy.

Already, analysts are saying that the demonetisation exercise will chip off at least 50-100 bp of India’s gross domestic product. If that is the case, RBI will likely come with a huge dose of a rate cut to prompt banks to make their loans cheaper. The cheap rates will prompt companies to borrow more for their long-term projects, which will then compensate for the fall in growth rate and also revive the economy.

Venkatesh expects at least 50-bp rate cut on December 7 policy by the RBI.

“Bond investors are factoring a host of possibilities pertaining to monetary easing and improvement in demand-supply dynamics. Although possibilities of such outcomes can’t be ruled out but the quantum of net actual benefits may vary depending upon various factors,” said Soumyajit Niyogi, associate director at India Ratings & Research (Ind-Ra).

“For the time being, the market will continue to focus on these (domestic factors) with lesser focus on global rate markets,” Niyogi said.

Globally, bond yields are rising after Donald Trump was elected the 45th US President. However, India has bucked the trend because of the demonetisation move. Even if rates harden from here, it won’t be as much as a complete reversal of the gains in the past few days, said bond dealers.

Again, there is another issue that in the present scenario, reverse repo rate, and not the repo rate, has become the operative policy rate. The bond yields will follow the policy rate closely and even if the yields fall sharply below the repo rate, it won’t be unusual for the bonds, said traders.

The fall in yields is also excellent news for the corporate borrowers. Not only will their borrowing rates come down on bank loans, corporate bond yields too will fall in tandem with the government bond yields.

That would mean cheaper cost of borrowing from the market for meeting working capital requirements and refinancing existing debt.

Meanwhile, banks on Tuesday parked Rs 4.43 lakh crore of their surplus cash with RBI, straining the RBI balance sheet as the central bank is running out of securities to mortgage against those deposits.

Ind-Ra said the RBI can issue short-term cash management bills (CMBs) to absorb the extra liquidity from the system. Apart from the CMBs, RBI also has other options and can issue special sterilisation bonds, increase cash reserve ratio, or even intervene in the foreign exchange market and sell dollars (thus, sucking out equivalent amount of rupee liquidity).

| Central bank's reverse repo ops                   |      |
|---------------------------------------------------|------|
| Strap: Surplus liquidity parked by banks with RBI |      |
| Rs lakh crore                                     |      |
| 22-Nov                                            | 4.43 |
| 21-Nov                                            | 4.33 |
| 18-Nov                                            | 3.57 |

|                                      |      |
|--------------------------------------|------|
| 17-Nov                               | 3.06 |
| 16-Nov                               | 2.49 |
| 15-Nov                               | 1.82 |
| 14-Nov                               | 1.36 |
|                                      |      |
| <i>Source: Reserve Bank of India</i> |      |